MULTIMEDIA UNIVERSITY

STUDENT ID NO

MULTIMEDIA UNIVERSITY

FINAL EXAMINATION

TRIMESTER 1 2022/2023 (TERM ID 2210)

BFE2074 – FINANCIAL ECONOMICS

(All sections / Groups)

17 FEBRUARY 2023
9.00 am to 11.00 am
(2 Hours)

INSTRUCTIONS TO STUDENTS

1. Excluding the cover page, this final examination paper consists of **TWO** pages of **FOUR** structured questions. Marks are shown for each question.
2. **Answer ALL questions** in the answer booklet provided.

Answer ALL questions.

Question One (25 marks)

Based on the monetary approach of the balance of payment, the money supply and demand equation is represented by Equation (1) below.

$$m(DC + FER) = kPy = kSP^*y \quad (1)$$

where m is the money multiplier, DC is domestic credit, FER is foreign exchange reserve, k is a fraction between zero and one, P is the aggregate domestic price level, P* is the aggregate foreign price level, S is the spot exchange rate and y is total real income.

Suppose that in a hypothetically small country Kemboja, the official domestic currency is K$. Its domestic credit equals K$100 million, foreign exchange reserves equal K$8 million, the money multiplier is 3, the fraction of nominal income that individuals desire to hold in money balances is 20 per cent, the foreign price level is 1.5, and the spot exchange value of the domestic currency is 2.

(a) Using this information, calculate the money stock in Kemboja. (4 marks)

(b) Based on the money stock in (a), calculate Kemboja's real income level. (4 marks)

(c) Suppose Kemboja's central bank increases its domestic credit by K$5 million through an open-market purchase of securities. Under flexible exchange rates
   i. Determine its central bank's action (2 mark)
   ii. Calculate the new exchange value of the domestic currency. (8 marks)

(d) The wealth identity, $W \equiv M + B + SB^*$ where W is wealth, M is domestic money, B is domestic bonds, B* is foreign bonds. Based on the wealth identity, contrast the explanation of the open-market purchase in (c) when Kemboja implement a fixed-exchange-rate regime. *(Hint: No calculation is required to answer this question).* (7 marks)

Question Two (25 marks)

(a) Determine why market interest yields vary with differences in financial instruments' terms to maturity. (6 marks)

(b) Identify what happens if the uncovered interest parity condition fails to hold. (6 marks)

(c) Examine how real interest rate differentials can serve as indicators of the extent to which international markets are open to arbitrage. (8 marks)

(d) Find two derivative risks of a particular financial instrument. (5 marks)

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Question Three (25 marks)

Suppose that in a hypothetically small and open country, Ixora, adopts a fixed exchange rate system. The central bank of Ixora conducts an unsterilized monetary policy.

(a) Analyse how would an expansionary monetary policy affect Ixora's balance of payments and real income, assuming that the price level is unchanged. (10 marks)

(b) If Ixora's capital mobility is very low, determine how a contractionary fiscal policy induces Ixora's money stock. (11 marks)

(c) Determine what the ***Locomotive Effect*** is. (4 marks)

Question Four (25 marks)

(a) Analyse the two basic policy objectives (goals) of an economy. (8 marks)

(b) Examine how greater openness can make real output less responsive to inflation. (12 marks)

(c) Diagnose if macroeconomic policies elevate domestic and global economic welfare. (5 marks)

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